

ST 97-9

Tax Type: SALES TAX

Issue: Books and Records Insufficient
Unreported/Underreported Receipts (Fraud)
Statute of Limitations Application

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE)	
OF THE STATE OF ILLINOIS)	No.
)	IBT No.
v.)	NTL No.
)	
TAXPAYER)	Charles E. McClellan
Taxpayer)	Administrative Law Judge
)	

RECOMMENDATION FOR DISPOSITION

APPEARANCES: Mark Dyckman, Special Assistant Attorney General, for the Department of Revenue; Akram Zanayed for TAXPAYER.

Synopsis:

This matter comes on for hearing pursuant to the taxpayer's timely protest of Notice of Tax Liability XXXXX (NTL) issued to TAXPAYER by the Department of Revenue dated December 27, 1994, for Retailers' Occupation Tax ("ROT") and Use Tax. The issues are whether the Department met a minimal standard of reasonableness in making its determination of additional tax due for the periods July 1987 through September 1993, and, if so, whether the under-reporting of gross receipts from sales and/or the overstatement of deductions during the audit period as determined by the Department was due to fraud. Following the submission of all evidence and a review of the record, it is recommended that this matter be resolved in favor of the Department on the issues of under-reporting of gross receipts and the overstatement of deductions, with one exception. It is recommended that this matter be resolved in favor of the

taxpayer with regard to the overstatement of deductions for newspapers and magazines.

Findings of Fact:

1. The Department's *prima facie* case against TAXPAYER, including all jurisdictional elements, was established by the admission into evidence of the Correction of Returns, showing tax due for the periods July 1987 through September 1993 of \$47,083, fraud penalty of \$16,643 and interest of \$31,379 for a total liability due and owing in the amount of \$103,499. (Tr. pp. 20-22; Dept. Grp. Ex. No. 1).

2. Taxpayer is a small neighborhood liquor and food store selling food, liquor, candy, chips, pop and cigarettes. (Dept. Grp. Ex. No. 2; Tr. pp. 26, 53).

3. The sole owner of the business is OWNER. (Dept. Grp. Ex. No. 2).

4. The store had no employees but was operated by OWNER until 1991 when his brother, BROTHER, began working in the store. *Id.*

5. OWNER registered ENTERPRISES, d/b/a TAXPAYER with the Department on April 2, 1987 and was assigned IBT No. XXXXX. (Dept. Grp. Ex. No. 4).

6. The corporation was involuntarily dissolved by the Secretary of State's office on August 1, 1990, for failure to pay a franchise fee and file an annual report after which OWNER continued to operate the business as an individual. (Dept. Grp. Ex. No. 4).

7. This case arose out of a referral from the Department's Bureau of Criminal Investigations. (Tr. p. 26).

8. The criminal investigation disclosed that for the periods January 1989 through May of 1992, the taxpayer's purchases of high rate items totaled \$655,215 and taxpayer's reported high rate sales were \$319,390, resulting in unreported sales of \$330,869, after taking inventory adjustments into account. (Dept. Grp. Ex. No. 4).

9. Taxpayer always used a 25% markup on his cost to determine his selling prices. *Id.*

10. The 25% markup was the same as was reported on taxpayer's federal income tax returns and is consistent with taxpayer's industry. (Dept. Grp. Ex. No. 3).

11. Taxpayer has one cash register. (Dept. Grp. Ex. No. 4).

12. Taxpayer's sales tax returns were prepared by an independent accountant. (*Id.*; Tr. p. 54).

13. The independent accountant received the numbers to report on the sales tax returns by telephone from Mr. OWNER. (Dept. Grp. Ex. No. 4; Tr. p. 43, 54).

14. OWNER never supplied his accountant with adding machine tapes although the accountant requested them. (Dept. Grp. Ex. No. 4).

15. Taxpayer does not keep year end inventory sheets. (Tr. p. 58).

16. OWNER signed the incorrect monthly tax returns. (Tr. p. 29)

17. The Department's auditor was not provided with a general ledger and the taxpayer did not maintain one. (Tr. pp. 27, 58).

18. The Department's auditor reviewed invoices, sales tax returns, federal income tax returns and a letter sent to the Department by the U.S. Department of Agriculture confirming the amount of taxpayer's food stamp redemptions. (Tr. p. 26).

19. To establish the sales tax liability for this taxpayer, the Department's auditor scheduled sample months for the non-food purchases for 1989, 1990 and 1991 and used the 25% markup to determine sales. (Tr. pp. 27, 28, 31).

20. Because there were no books and records for 1987 and 1988, the Department's auditor, developed the liability for those years by projecting back the same sample error from 1989, 1990 and 1991. (Tr. p. 34).

21. The auditor disallowed the deductions for newspapers and magazines because there were no supporting documents for these deductions. (Tr. p. 28).

22. The auditor disallowed food stamp deductions because the taxpayer had deducted more than the U.S. Department of Agriculture confirmed by letter. *Id.*

23. The auditor disallowed deductions for food sales because her test check indicated that those deductions were overstated. *Id.*

24. The auditor disallowed deductions for Chicago and state sales tax because the taxpayer did not provide cash register tapes. (*Id.*; Tr. p. 32)

25. The taxpayer turned over to the Bureau of Criminal Investigations agent ("BCI agent") two boxes of records that consisted of packets in manila folders which contained his bills from 1989 through 1992. (Tr. pp. 36, 37).

26. The BCI agent examined but never took possession of the red notebook in which the taxpayer recorded some of his transactions. (Tr. pp. 36, 37; Dept. Grp Ex. No. 4).

27. There were no inventory records, cash register tapes nor a general ledger in the two boxes of records taken by the BCI agent. *Id.*

28. Taxpayer's records that were contained in the boxes turned over to the BCI agent were lost while in the custody of the Department and have not been found. (Tr. pp. 46-49).

29. The administrative law judge that presided at the hearing in this matter granted taxpayer's motion for a directed finding regarding any deductions based on the lost documents. (Tr. p. 50)

Conclusions of Law:

The record in this case, shows that this taxpayer has failed to demonstrate by the presentation of testimony or through exhibits or argument, evidence sufficient to overcome the Department's *prima facie* case of tax liability under the assessments in question, except for so much of the liability as results from the deductions for magazines and newspapers. Accordingly, by such failure, and under the reasoning given below, the determination by the Department that TAXPAYER owes the assessments shown on the Corrections of Return must stand as a matter of law, except for that part of the determination that results from the disallowance of the deduction for magazines and newspapers. Because the

taxpayer's records misplaced by the Department might have allowed taxpayer to rebut the Department's determination with regard to the deductions for magazines and newspapers, taxpayer must be allowed the deduction claimed for those items. In support thereof, the following conclusions are made:

ISSUE # 1

The first issue to be decided is whether the Department met a minimal standard of reasonableness in making its determination of additional tax due for the periods July 1987 through September 1993. When a taxpayer fails to supply the Department with records to substantiate its gross receipts, the Department is justified in using the markup method to estimate the taxpayer's gross receipts, and, in doing so, the Department is required only to meet a minimum standard of reasonableness. Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill.App.3d 203 (1st Dist. 1991). In this case, neither the BCI agent nor the Department's auditor were provided with cash register tapes, or a general ledger. The auditor reviewed invoices, sales tax returns, federal income tax returns and a U.S. Department of Agriculture letter regarding food stamp redemptions. She scheduled sample months for the non-food purchases for 1989, 1990 and 1991 and used the 25% markup percentage that the taxpayer used. Because the Department's auditor had been provided with no books and records for 1987 and 1988, she developed the liability for those years by projecting back the same sample error from 1989, 1990 and 1991. The same method was used by the Department in another case in which the court held that it met the required minimum standard of reasonableness. Vitale v. Department of Revenue, 118 Ill.App.3d 210 (3d Dist. 1983). Therefore, since the taxpayer in this case provided no books and records to the Department to substantiate the sales figures it reported on its retailers' occupation tax returns, the Department was justified in using the markup method, and, by so doing the Department satisfied the requirement to meet a minimum standard of reasonableness.

At the hearing in this case, the Department introduced into evidence the Department's correction of return documents, the audit comments section of the

auditor's report, the auditor's letter to the field audit manager requesting the issuance of civil fraud penalty for the audit period and which set forth the factors justifying the imposition of the civil fraud penalty, and the BCI agent's investigative summary report. These documents, coupled with the uncontroverted testimony of the Department's auditor, show that the Department's determination was not arbitrary or unreasonable, but rather was based on reasonable statistical assumptions. The Department's technique was made necessary because the taxpayer did not produce adequate books and records for examination. See Vitale, *supra* at 212. The auditor stated in the comments section of her audit report that she used the best information available. That is all that is required. Central Furniture Mart v. Johnson, 157 Ill.App. 3d 907 (1st Dist. 1987).

A corrected return prepared by the Department is deemed *prima facie* correct and the Department establishes its *prima facie* case by having the corrected return admitted into evidence. (35 ILCS 120/4) Central Furniture Mart v. Johnson, 157 Ill.App.3d 907 (1st Dist. 1987). Therefore, when the Department had the corrected returns introduced into evidence, its *prima facie* case was established.

A taxpayer cannot overcome the Department's *prima facie* case merely by denying the accuracy of the Department's determination. Central Furniture Mart v. Johnson, *supra*. Simply questioning the Department's assessment or denying its accuracy is not enough. Quincy Trading Post v. Dept of Revenue, 12 Ill App.3d 725 (4th Dist. 1973). A taxpayer can overcome the Department's *prima facie* case by producing competent evidence identified with the taxpayer's books and records. Vitale, *supra*, at 213. In this case the taxpayer presented no documentary evidence whatsoever to show that the Department's determination was arbitrary, capricious or unreasonable.

Taxpayer argues that it was fatally prejudiced by the Department's loss of the records taken by the BCI agent from taxpayer's premises and, for that reason, that the assessment should be abated. (Tr. pp. 5, 46, 47). Section 7

of the ROT requires retailers to "keep records and books of all sales of tangible personal property, together with invoices, bills of lading, sales records, copies of bills of sale, inventories prepared as of December 31 of each year or otherwise annually as has been the custom in the specific trade and other pertinent papers and documents." (35 ILCS 120/7). Retailers are required to keep ledger accounts, journal entries, and complete books and records covering receipts from all sales and distinguishing taxable from non-taxable receipts. (86 Admin. Code ch.I, § 130.801).

The record in this case indicates that no general ledger was kept. It also indicates that cash register tapes, if any ever existed, were not available, even to the taxpayer's independent accountant who prepared taxpayer's sales tax returns. The record also indicates that taxpayer did not maintain inventory records as required by the statute. The taxpayer testified that he maintained a red notebook in which he recorded his business and that the notebook is now missing. The BCI agent testified that he examined this notebook and found it to contain limited information regarding taxpayer's business for a couple of months. This notebook with limited information regarding two months of business activity did not come close to satisfying the statutory record keeping requirement. In addition, the BCI agent testified that he never took possession of the notebook and his testimony on this point is uncontradicted. The record indicates that even if the notebook were available, it would be of little or no use to taxpayer in trying to overcome the Department's *prima facie* case. For these reasons and the fact that the Department never took custody of the notebook, its unavailability is not grounds for a finding in favor of the taxpayer.

Insofar as the other lost records are concerned, the record shows that their loss caused taxpayer very little prejudice. The record indicates that they were contained in two boxes that the BCI agent took into custody and that the boxes contained invoices. These boxes did not contain sales journals, cash register tapes, or ledgers as required by statute. Therefore, even if the

records had not been lost, taxpayer still would not have been able to produce the records required by statute. With regard to unreported sales, the BCI agent did not use the invoices in the boxes to make his determination. Instead, he subpoenaed records from taxpayer's suppliers and used that information to determine taxpayer's unreported sales. When the auditor made her determination the results were consistent with what the BCI agent determined from an independent source. Therefore, with regard to unreported sales, the taxpayer was not prejudiced by the fact that the records were lost.

The auditor's disallowance of the food stamp redemption deduction had nothing to do with the lost records. It was based on redemptions recorded by the U.S. Department of Agriculture from stamps submitted by the taxpayer. Thus, the taxpayer was not prejudiced in this regard by the lost books.

The auditor disallowed deductions for sales taxes because the taxpayer did not produce cash register tapes showing that he separately stated the tax when he charged customers for merchandise sold. Even the taxpayer's independent accountant was unable to obtain cash register tapes. There is nothing in the record to show that the loss of any records in the two boxes taken by the BCI agent prejudiced the taxpayer with regard to the disallowance of the sales tax deduction.

The administrative law judge that conducted the hearing recognized the fact that the taxpayer would have been prejudiced with regard to any disallowed deductions for which the lost records might have relevancy and granted taxpayer's motion for a finding in taxpayer's favor with regard to such deductions. The record shows that the magazine and newspaper deductions were the only deductions that fell into that category. Therefore, the magazine and newspaper deductions should be allowed as claimed on the taxpayer's sales tax returns. For the reasons stated above, except for the portion of the Department's assessment related to the magazine and newspaper deductions, the Department's determination of tax due should be sustained.

The second issue to be decided is whether the under-reporting of sales determined by the Department was due to fraud. Where civil fraud under Section 4 of the ROT (35 ILCS § 120/4) is alleged, the Department must show intent. Intent for this purpose can be shown by circumstantial evidence. Vitale, *supra* at 213. In the Vitale case, *supra*, the court found the necessary intent from a number of facts, including the following: the taxpayer had understated his gross receipts by as much as 200%; in one year the taxpayer's purchases exceeded his sales by 46%; finally, the taxpayer failed to maintain business records. Vitale, *supra* at 213.

In this case, the taxpayer also failed to maintain business records. The BCI agent determined that the non-food items purchased by the taxpayer during the audit period exceeded by 105% the sales of non-food items reported by the taxpayer during the audit period and the reported sales contained a 25% markup. The taxpayer claimed food stamp redemptions in excess of the amount of food stamps redeemed during the audit period as confirmed by the U.S. Department of Agriculture and the taxpayer overstated his deduction for food sales. The record in this case contains clear and convincing circumstantial evidence of intent to commit fraud. Therefore, the Department's assessment of fraud penalties must be sustained.

WHEREFORE, for the reasons stated above, it is my recommendation that the Department's assessment of additional tax be upheld, except for that portion that resulted from the disallowance of the deductions for magazine and newspaper sales, and the assessment of fraud penalties on the adjusted assessment must be sustained.

Date

Charles E. McClellan
Administrative Law Judge